Underground Economy
IRS Enforcement Procedures

California Tax Policy Conference

November 13-15, 2002

CHARLES P. RETTIG, Esq.
Hochman, Salkin, Rettig, Toscher & Perez, P.C.
9150 Wilshire Boulevard, Suite 300
Beverly Hills, California 90212
Telephone: (310) 281-3200   Fax: (310) 859-5104
rettig@taxlitigator.com
www.taxlitigator.com

IRS Enforcement Procedures

CHARLES P. RETTIG, Esq.
Hochman, Salkin, Rettig, Toscher & Perez, P.C.
9150 Wilshire Boulevard, Suite 300
Beverly Hills, California 90212
Telephone: (310) 281-3200   Fax: (310) 859-5104
rettig@taxlitigator.com
www.taxlitigator.com

I.

INTERNAL REVENUE SERVICE

History and Structure

www.irs.gov

The Internal Revenue Service is the nation=s tax collection agency and administers the Internal Revenue Code enacted by Congress. Its mission: Ato provide America=s taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.@

The IRS, a branch of the Department of Treasury, deals directly with more Americans than any other institution, public or private. In 2000, the IRS collected more than $2 trillion in revenue and processed 226 million tax returns. It cost taxpayers 39-cents for each $100 collected by the IRS, the lowest cost/collection ratio since 1954. In 2000, IRS assisted more than 100 million taxpayers who called the toll-free automated telephone line, wrote letters or visited one of the more than 400 offices the IRS maintains nationwide.

A.

Historical Highlights of the IRS.

The IRS has a long history going back to the Civil War when President Lincoln and Congress, in 1862, created the Commissioner of Internal Revenue and enacted an income tax to pay war expenses. The income tax was repealed 10 years later. Congress revived the income tax in 1894, but the Supreme Court ruled it unconstitutional the following year.

In 1913, the states ratified the 16th Amendment, which gave Congress the authority to enact an income tax. That same year, Congress introduced the FIRST FORM 1040 and levied a 1% tax on net personal incomes above $3,000 with a 6% surtax on incomes of more than $500,000. As the nation sought greater revenue to finance World War I, the top income tax rate rose to 77%. World War II brought payroll withholding and quarterly tax payments.

1862 - President Lincoln signed into law a revenue-raising measure to help pay for Civil War expenses. The measure created a Commissioner of Internal Revenue and the nation=s first income tax. It levied a 3% tax on incomes between $600 and $10,000 and a 5% tax on incomes of more than $10,000.
1867 - Heeding public opposition to the income tax, Congress cut the tax rate. From 1868 until 1913, 90% of all revenue came from taxes on liquor, beer, wine and tobacco.
1872 - Income tax repealed.
1894 - The Wilson Tariff Act revived the income tax and created an Income Tax Division within the Bureau of Internal Revenue was created.
1895 - Supreme Court ruled the new income tax unconstitutional on the grounds that it was a direct tax and not apportioned among the states on the basis of population. The Income Tax Division was disbanded.
1909 - President Taft recommended Congress propose a constitutional amendment that would give the government the power to tax incomes without apportioning the burden among the states in line with population. Congress also levied a 1% tax on net corporate incomes of more than $5,000.
1913 - As the threat of World War I loomed, Wyoming became the 36th and last state needed to ratify the 16th Amendment. The amendment stated, ACongress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.@ Later, Congress adopted a 1% tax on net personal income of more than $3,000 with a surtax of 6 % on incomes of more than $500,000. It also repealed the 1909 corporate income tax. *The first Form 1040 was introduced*.
1918 - The Revenue Act of 1918 raised even greater sums for the World War I effort. It codified all existing tax laws and imposed a progressive income-tax rate structure of up to 77%.
1919 - The states ratified the 18th Amendment, barring the manufacture, sale or transport of intoxicating beverages. Congress passed the Volstead Act, which gave the Commissioner of Internal Revenue the primary responsibility for enforcement of Prohibition. Eleven years later, the Department of Justice assumed primary prohibition enforcement duties.
1931 - The IRS Intelligence Unit used an undercover agent to gather evidence against gangster Al Capone. Capone was subsequently convicted of tax evasion and sentenced to 11 years.
1933 - Prohibition repealed. IRS again assumed responsibility for alcohol taxation the following year and for administering the National Firearms Act. Later, tobacco tax enforcement was added.
1942 - The Revenue Act of 1942, hailed by President Roosevelt as Athe greatest tax bill in American history,@ passed Congress. It increased taxes and the number of Americans subject to the income tax. It also created deductions for medical and investment expenses.
1943 - Congress adopted the Current Tax Payment Act, which required employers to withhold taxes from employees= wages and remit them quarterly.
1944 - Congress passed the Individual Income Tax Act, which created the standard deductions on Form 1040.
1952 - President Truman proposed his Reorganization Plan No. 1, which replaced the patronage system at the IRS with a career civil service system. It also decentralized service to taxpayers and sought to restore public confidence in the agency.
1953 - President Eisenhower endorsed Truman=s reorganization plan and changed the name of the agency to the Internal Revenue Service from the Bureau of Internal Revenue.
1954 - The filing deadline for individual tax returns changed to April 15 from March 15.
1961 - The IRS computer age began with the dedication of the National Computer Center at Martinsburg, West Virginia.

1965 - IRS instituted first toll-free telephone site.
1972 - The Alcohol, Tobacco and Firearms Division separated from the IRS to become the independent Bureau of Alcohol, Tobacco and Firearms.
1974 - Congress passed the Employee Retirement and Income Security Act, which gave regulatory responsibilities for employee benefit plans to the IRS.
1986 - Limited electronic filing began.
1986 -President Reagan signed the Tax Reform Act, the most significant piece of tax legislation in 30 years. It contained 300 provisions and took three years to implement. The act codified the federal tax laws for the third time since the Revenue Act of 1918.
1992 - Taxpayers who owed money were allowed to file returns electronically.
1998 - Congress passed the IRS Restructuring and Reform Act, which expanded taxpayer rights and called for reorganizing the IRS into four operating divisions aligned according to taxpayer needs.
2000 - IRS enacted reforms, ending its geographic-based structure and instituting four major operating divisions: Wage and Investment Income, Small Business/Self-Employed, Large and Mid-Size Business and Tax Exempt and Government Entities. It was the most sweeping change at the IRS since the 1953 reorganization.
2001 - IRS administered a mid-year tax credit program called the Advance Tax Credit Payment. Electronic filing reaches an all-time high, 40.2 million tax returns or more than 30% of all returns.

B.
Structure of the IRS

In the 1950s, the IRS was reorganized to replace the patronage system with career, professional employees. Now, only the IRS Commissioner and Chief Counsel are selected by the president and confirmed by the Senate. The Bureau of Internal Revenue name also was changed to the Internal Revenue Service to emphasize Aservice@ to taxpayers. For the 2002 fiscal year, the IRS has approximately 100,000 employees (full-time equivalent) and a budget of approximately $9.4 billion

IRS Commissioner Charles O. Rossotti has been presiding over the biggest reorganization and modernization efforts in nearly half a century. The IRS Restructuring and Reform Act of 1998 resulted in the IRS reorganizing itself into four major operating divisions, aligned by types of taxpayers.

Wage and Investment Business Division (W&I) - Servicing approximately 116 million taxpayers who file individual and joint tax returns.

Small Business / Self-Employed Business Division (SB/SE) - Servicing approximately 45 million small businesses and self-employed taxpayers.

Large and Mid-Sze Business Division (LMSB) - Servicing corporations with assets of more than $10 million.

Tax Exempt / Governmental Entities Business Division (TE/GE) - Servicing employee benefit plans and tax-exempt organizations such as nonprofit charities and governmental entities.

Taxpayer Advocate Service: The Taxpayer Advocate Service helps taxpayers resolve problems with the IRS and recommend changes to prevent the problems by providing an independent system to assure that tax problems, which have not been resolved through normal channels, are promptly and fairly handled. The National Taxpayer Advocate, Nina Olson, heads the program. Each state and service center has at least one local Taxpayer Advocate, who is independent of the local IRS office and reports directly to the National Taxpayer Advocate. The goals of the Taxpayer Advocate Service are to protect individual taxpayer rights and to reduce taxpayer burden. The Taxpayer Advocate independently represents the taxpayers interests and concerns within the IRS by:

- Ensuring that taxpayer problems, which have not been resolved through normal channels, are promptly and fairly handled;
- Identifying issues that increase burden or create problems for taxpayers: Bringing those issues to the attention of IRS management and making legislative proposals where necessary.

IRS Appeals: Appeals provides taxpayers with an independent impartial review of their cases after an audit is completed or collection action is proposed. It is the last opportunity for the IRS and the taxpayer to agree before a case goes to court. Appeals plays a critical role in ensuring that taxpayers have an opportunity to resolve their dispute.

Keys to the success of the Appeals function include three factors: its independence, impartiality and fairness. Appeals current focus is on resolving taxpayer disputes faster, such as Fast Track Mediation and the Mutually Accelerated Appeals Process. The Fast Track Mediation program allows examiners and SB/SE taxpayers an opportunity for mediation, with an IRS Appeals Officer acting as a mediator, to assist the parties in resolving their disputes. Under the Mutually Accelerated Appeals Process, Appeals and the taxpayer set accelerated timelines and apply additional resources to more quickly resolve large, complex corporate cases .

II.

IRS CRIMINAL INVESTIGATION ENFORCEMENT INITIATIVES

IRS Criminal Investigation (CI) investigates potential criminal violations of the Internal Revenue Code and related financial crimes. The CI organization functions as a separate line organization reporting directly to the Commissioner. The chain of command consists entirely of CI personnel and flows from the field to the Chief. The structure of CI is based in part on recommendations made in the Webster Report, an independent study conducted by former FBI and CIA Director, William Webster. The management team for CI includes the Chief and Deputy Chief, Criminal Investigation; Headquarters program heads with the title of Director; Directors, Field Operations; and territory managers known as Special Agents-in-Charge. There are six Directors, 35 Special Agents-in-Charge (SAC) located in field offices throughout the nation and 10 Resident Agents-in-Charge (RAC) in each of the service centers. The CI territory offices are aligned with the boundaries of the Federal judicial districts to enable each U.S. Attorney=s Office to have contact with only one CI office. Criminal Investigation posts Special Agents in foreign countries to facilitate the exchange of information.

Tax Law Violation Hotline: 1-800-829-0433

CI Public Website: **www.treas.gov/irs/ci**

In July 1998, the Commissioner appointed former U.S. District Court Judge William H. Webster to direct an independent review of CI and assess its effectiveness in accomplishing its mission as the criminal enforcement arm of the IRS. Judge Webster=s report (theAWebster Report@) was issued April 1999, and among its findings was a general conclusion that CI had drifted from its primary mission as enforcer of the nation=s tax laws, at least in part as a consequence of its expanded jurisdiction over money laundering, currency reporting and drug-related crimes.

On October 1, 1999, CI developed a compliance strategy which identified three separate segments of CI=s investigative efforts: Legal Source Tax Cases (commonly referred to as Title 26 cases although this segment also includes Title 18 violations such as 286, 287 and 371K.); Illegal Source Financial Crimes (which includes Title 18 and Title 26 violations as well as money laundering violations); and Narcotics-Related Financial Crimes (which includes both tax and money laundering violations.).

Tax cases continue to be the top priority for CI as the only agency responsible for the enforcement of tax crimes. Criminal Investigation continues to work money laundering and illegal source income cases, along with narcotics related financial crimes. Criminal Investigation focuses on significant cases where CI specifically brings their unique skills to the table and on tax administration cases.

In response to the Webster Report, CI has Areturned to its roots,@ by enhancing the fraud referral process from the civil IRS audit function, with the implementation of the Fraud Referral Specialists Program. There are 64 Fraud Referral Specialists and five managers across the nation who now work on a consultative basis with IRS civil Revenue Agents in an effort to develop CI referrals from civil tax audits. CI has also taken steps to redirect more of its agents away from joint drug task forces and from other investigations where CI Special Agents served only as an adjunct to a criminal investigation that consisted primarily of nontax criminal charges. CI Special Agents have now become more focused on developing the Agarden variety@ tax fraud cases and combating perceived abuses of the Internal Revenue Code.

Current IRS criminal enforcement initiatives include:

1. *Legal Source Tax Crimes.* The traditional Agarden variety tax criminal@ is involved in a legitimate business, but also engages in illegal conduct to divert income, willfully evades filing and payment obligations, or assists others in similar conduct. CI=s primary commitment is to investigate these types of activities. As stated in the Webster Report, prosecution of legal source tax crimes enhances voluntary compliance with the tax laws and promotes fairness and equity in the tax system. This tax compliance program is actively focusing its resources on the following types of cases:

    1. *Abusive Trust Schemes.* Within the last few years there has been a proliferation of abusive trust tax evasion schemes involving both domestic and foreign trusts. The trusts involved in such schemes are usually vertically layered with each trust distributing income to the next layer. These schemes give the appearance of separation of control from the benefits of ownership which, in turn, provides the sense of Anontaxability.@ The reality of these schemes, however, is that the taxpayer who is at the beginning of the scheme does not lose effective control of the funds that have been filtered through a series of trusts, because the funds are often returned or made available to the taxpayer by way of debit card, wire transfer or other means. Tax haven countries often serve as the situs for a trust bank account or other entity used to facilitate the flow of money offshore and then back to the taxpayer.

       Currently, there are two prevalent fraudulent schemes being promoted: the Adomestic scheme@ and the Aforeign scheme.@ The domestic scheme involves a series of trusts that are formed in the U.S., while the foreign trust scheme is formed offshore and outside the jurisdiction of the U.S. The trusts involved in the schemes, either foreign or domestic, are vertically layered with each trust distributing income to the next layer. The result of this layered distribution of income is to fraudulently reduce taxable income to nominal amounts. Although these schemes give the appearance of the separation of responsibility and control from the benefits of ownership, these schemes are in fact controlled and directed by the taxpayer.

       CI=s enforcement strategy to combat these schemes is to focus primarily on promoters and on clients who have willfully used the promotion to egregiously evade tax. Further, fraudulent trust issues are addressed through a national strategy that includes CI, the IRS Examination and Collection Divisions, IRS Chief Counsel=s Office, and the Department of Justice. As part of this strategy, emphasis is placed on multi-function coordination, the identification of fraudulent offshore promotions, and the use of civil and criminal enforcement actions.

       It is very difficult to determine precisely the amount of fraud attributable to these schemes because of their design and inherent complexity. However, it can be said that these schemes are directed towards taxpayers with at least six figure incomes, and as evidenced by the individual cases detailed later in this summary, the potential for lost tax revenue could be massive.

Because this is a new area of fraud, CI has been tracking these investigations only since October 1998. The following statistics represent CI=s efforts on promoters, clients, and other individuals involved in abusive trust schemes.

	Fiscal Year 1999	Fiscal Year 2000	Fiscal Year 2001	Fiscal Year 2002 (October 1 2001- April 30, 2002)
Criminal Investigations Initiated	67	47	79	75
Prosecution Recommendations	57	44	30	47
Indictments/Informations	35	53	32	32
Convictions	24	31	45	13
Incarceration* Rate	85.7%	93.1%	80.8%	88.5%
Avg. Months to Serve (w/prison)	35	33	64	37
Avg. Months to Serve (all Sent)	30	31	52	33

* Incarceration may include prison time, home confinement, electronic monitoring, or a combination thereof.

Fiscal Year 2002, runs October 1, 2001, through September 30, 2002.

The following data is on foreign and domestic trust investigations as of December 31, 2001.

Open Criminal Investigations	160
Percent of Open Investigations on Foreign Schemes	71%
Percent of Open Investigations on Domestic Schemes	29%

2. *National Nonfiler Strategy.* This program is a prime example of the IRS undertaking a Acarrot and stick@ approach to tax compliance. Since the Restructuring and Reform Act of 1998, the IRS has undertaken unprecedented efforts to educate the American tax paying public on their obligations to file returns and pay taxes. Now more than three years later, CI is actively pursuing

persons who rely on frivolous constitutional arguments, Aanti-taxation@ programs, and other frivolous tax arguments as a basis for not filing their tax returns.

The following nonfiler statistics represent CI==s efforts in the past three full fiscal years, along with the first quarter of fiscal year 2002:

Nonfiler Statistics*

	FY 1999	FY 2000	FY 2001	FY 2002 (10/1/01-4/30/02)
Prosecution Recommendations	310	257	269	146
Indictments/Informations	301	265	257	130
Convictions	289	232	219	121
Incarceration Rate**	78.7%	80.1%	83.9%	86.3%
Avg. Months to Serve (w/Prison)	47	39	43	48
Avg. Months to Serve (all Sent)	45	33	36	48

* All investigations that are initiated in one year are not necessarily recommended for prosecution, indicted and/or convicted in the same year.

** Incarceration may include prison time, halfway house, home confinement, or a combination thereof.

3. *Employment Tax Enforcement Program.* Employers are required by law to withhold employment taxes (federal income tax withholding and social security and medicare taxes) from their employees. Employers must also pay their share of social security taxes and federal unemployment tax. Often, these taxes must be paid with the employer=s payroll and are reported on quarterly returns filed by the employer. Employment tax evasion schemes include paying employees in cash, accruing employment tax liabilities in a successive string of tax periods and sometimes in different entities (this practice is called Apyramiding@), using strawman companies to pay workers, and other similar schemes.

Employment tax evasion schemes can take a variety of forms. Some of the more prevalent methods of evasion include pyramiding, employee leasing, paying employees in cash, filing false payroll tax returns or failing to file payroll tax returns.

APyramiding@ of employment taxes is a fraudulent practice where a business withholds taxes from its employees but intentionally fails to remit them to the IRS. Businesses involved in pyramiding frequently file for bankruptcy to discharge the liabilities accrued and then start a new business under a different name and begin a new scheme.

Employee leasing is another legal business practice, which is sometimes subject to abuse. Employee leasing is the practice of contracting with outside businesses to handle all administrative, personnel, and payroll concerns for employees. In some instances, employee-leasing companies fail to pay over to the IRS any portion of the collected employment taxes. These taxes are often spent by the owners on business or personal expenses. Often the company dissolves, leaving millions in employment taxes unpaid.

Paying employees in whole or partially in cash is a common method of evading income and employment taxes resulting in lost tax revenue to the government and the loss or reduction of future social security or Medicare benefits for the employee.

Preparing false payroll tax returns understating the amount of wages on which taxes are owed, or failing to file employment tax returns are methods commonly used to evade employment taxes.

During Fiscal Years 1998, 1999, and 2000, nearly 86 percent of the persons convicted of evading employment taxes were sentenced to an average of 17 months in prison and ordered to make restitution to the government for the taxes evaded (plus interest and penalties.)

	Three Year Totals	**FY 2001**	**FY 2002** Seven Months(10/1//01 - 4/30/02)
Investigations Initiated	112	64	54
Prosecution Recommendations	159	40	23
Indictments/Informations	137	33	34
Sentenced	127	31	27

	Three Year Average	**FY 2001**	**FY 2002** Seven Months(10/1//01 - 4/30/02)
Incarceration Rate*	85.8%	74.2%	88.9%
Average Months to Serve	17	20	18

* *Incarceration includes confinement to federal prison, halfway house, home detention, or some combination thereof.*

4. *Return Preparer Program (RPP).* The CI Return Preparer Program (RPP) was implemented in 1996, and established procedures to foster compliance by identifying, investigating and prosecuting abusive return preparers. The program was developed to enhance compliance in the return-preparer community by engaging in enforcement actions and/or asserting appropriate civil penalties against unscrupulous or incompetent return preparers. Abusive return preparers frequently prepare bad returns for large numbers of taxpayers who, at best, are stuck with paying additional taxes and interest and at worse, depending on culpability, are subject to penalties and maybe even criminal prosecution.

Return Preparer Fraud generally involves the orchestrated preparation and filing of false income tax returns (in either paper or electronic form) by unscrupulous preparers who may claim, for example:

- Inflated personal or business expenses
- False deductions
- Unallowable credits or excessive exemptions
- Fraudulent tax credits, such as the Earned Income Tax Credit (EITC)
- Preparing fraudulent Schedule C, Profit or Loss from Business, claiming deductions for expenses that have not been paid by the taxpayer to offset Form 1099, Miscellaneous Income, or income earned from outside employment
- Including false and inflated itemized deductions on Schedule A, Itemized Deductions, for charitable contributions and medical and dental expenses
- Claiming false Schedule E, Supplemental Income and Loss, losses
- Claiming false dependents

IRS Criminal Investigation Return Preparer Statistics for four full fiscal years (October 1, 1998 - September 30, 2001).

Investigations Initiated	468
Prosecution Recommendations	303
Indictments/Informations	291

Convictions	283
Incarceration Rate*	92.9%
Avg. Months to Serve (w/Prison)	20
Avg. Months to Serve (all Sent.)	18

NOTE: *Incarceration may include prison time, home confinement, electronic monitoring, or a combination thereof.

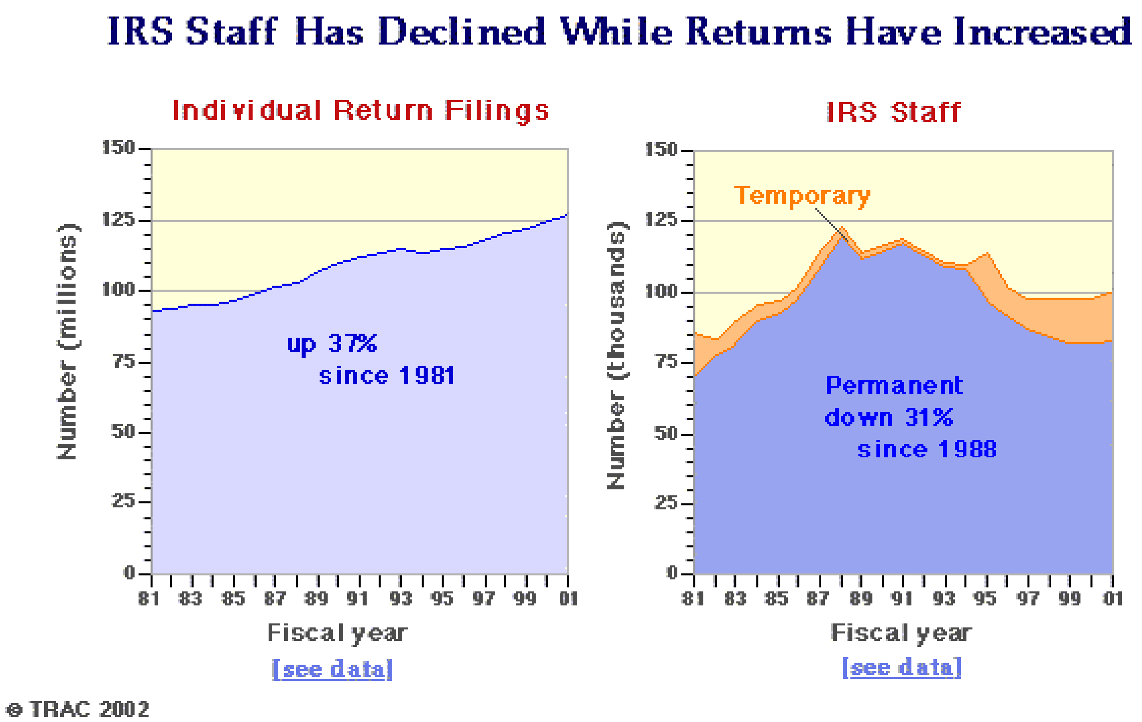
2. *Illegal Source Financial Crimes Program.* This program focuses its investigations on money gained through illegal sources such as illegal gambling operations, drug activity and other untaxed monies derived from the Aunderground economy.@ These investigations often uncover money laundering activities, as proprietors of illegal businesses attempt to Alaunder@ their illegal proceeds through legitimate businesses. Currency violations are often joined with tax violations. Also, the CI and DOJ often avail themselves of civil and criminal forfeiture actions to deprive individuals and organizations of their illegally obtained cash and assets.

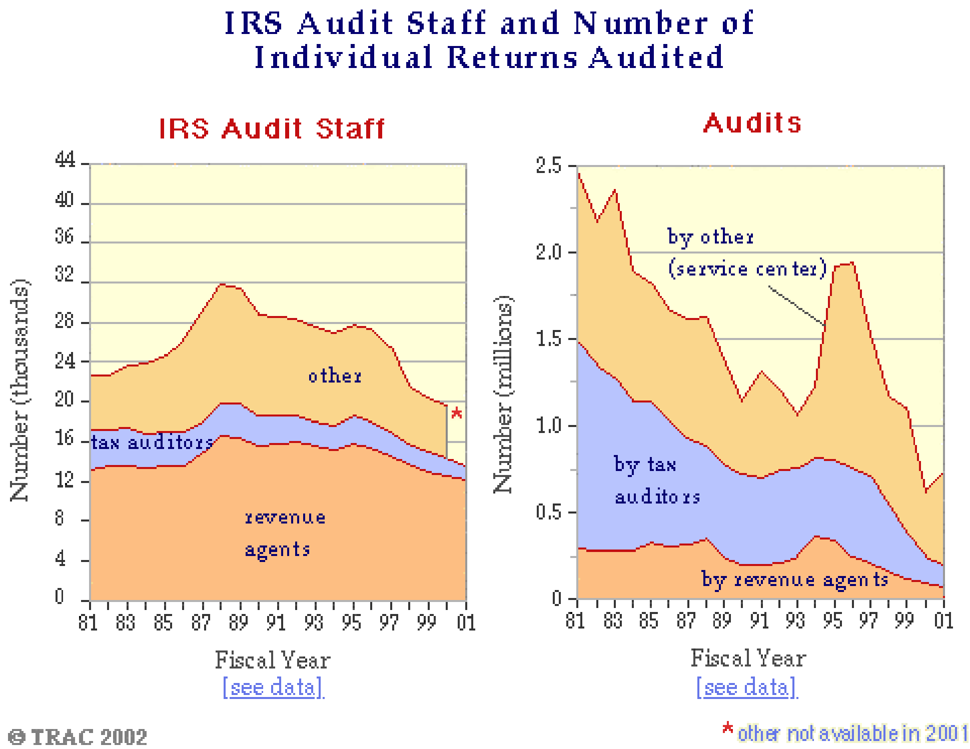
3. *Narcotics-Related Financial Crimes Program.* This program focuses its efforts on reducing the profit and financial gains of narcotics trafficking and money laundering organizations. CI traces illegal drug proceeds and contributes to the prosecution of criminal organizations by investigating money laundering violations, currency reporting violations and related conduct. These investigations are often global in nature and, as such, CI enlists the cooperation of foreign governments to obtain information, assistance and investigative resources.

4. *Anti-Terrorism Task Forces.* Since September 11, 2001, CI Special Agents have responded to a number of requests for assistance in the war against terrorism. These agents work with other Department of Treasury agents and Special Agents from the FBI to track terrorist fund-raising activities, investigate money laundering of terrorist funds and to monitor terrorist networks. New High Intensity Money Laundering and Related Financial Crime Area Tax Forces (AHIFCA@) have been established in Chicago, Illinois and San Francisco, California. This added to the four HIFCAs already in effect in New York City, New York, San Juan, Puerto Rico, Los Angeles, California and in the Texas and Arizona-Mexican border areas.

III.

IRS ENFORCEMENT STATISTICS





IRS Office of Examination Staff(average positions realized)

Fiscal Year	All	Revenue Agents	Tax Auditors	Other
1981	22,716	13,184	4,032	5,500
1982	22,766	13,450	3,844	5,472
1983	23,661	13,563	3,791	6,307
1984	23,934	13,405	3,459	7,070
1985	24,798	13,557	3,513	7,728
1986	26,120	13,619	3,292	9,209
1987	29,243	14,944	3,105	11,194
1988	31,895	16,559	3,242	12,094
1989	31,315	16,486	3,327	11,502
1990	28,788	15,526	3,003	10,259
1991	28,592	15,738	2,842	10,012
1992	28,393	15,947	2,704	9,742
1993	27,490	15,541	2,556	9,393

1994	26,894	15,206	2,460	9,227
1995	27,808	15,869	2,732	9,207
1996	27,350	15,330	2,627	9,393
1997	25,593	14,591	2,344	8,659
1998*	21,599	13,687	2,128	5,784
1999	20,506	13,037	1,924	5,545
2000	20,419	12,527	1,689	6,203
2001	na	12,154	1,356	na

Source: Internal Revenue Service* In 1998, the figures no longer include IRS Service Center audit staff which were included in totals for prior years. IRS estimates that this change reduced Examination staff figures by approximately 2500 FTE=s (average positions realized). This change was the chief reason for the reduction in the "other" category shown above for 1998.

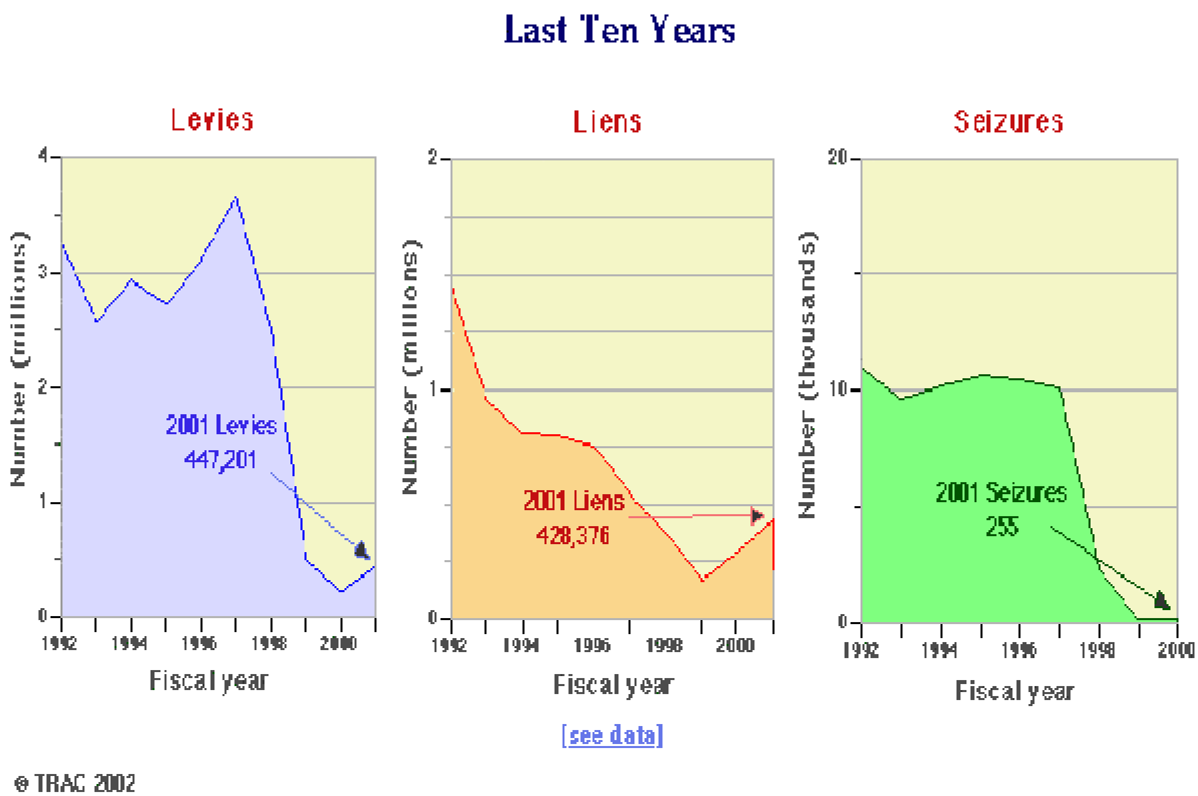
IRS "Face-to-Face" District Audits of Individual Income Tax Returns

Fiscal Year	Returns Filed*	Revenue Agent Audits	Tax Auditor Audits	Total District Audits	Percent Audited
1981	93,052,000	289,507	1,193,079	1,482,586	1.59
1982	94,013,000	285,526	1,066,537	1,352,063	1.44
1983	95,419,000	277,945	1,001,865	1,279,810	1.34
1984	95,541,300	276,182	859,351	1,135,533	1.19
1985	96,496,900	332,574	810,943	1,143,517	1.19
1986	99,529,000	298,943	732,456	1,031,399	1.04
1987	101,750,800	317,525	610,439	927,964	0.91
1988	103,251,000	352,808	532,326	885,134	0.86
1989	107,029,000	242,983	542,664	785,647	0.73

1990	109,868,400	202,570	516,749	719,319	0.65
1991	112,304,900	200,735	499,886	700,621	0.62
1992	113,829,200	210,166	536,640	746,806	0.66
1993	114,718,900	250,712	505,539	756,251	0.66
1994	113,754,400	364,016	456,216	820,232	0.72
1995	114,683,400	338,605	458,880	797,485	0.70
1996	116,059,700	252,430	509,420	761,850	0.66
1997	118,362,600	209,781	505,834	715,615	0.60
1998	120,342,400	168,054	383,366	551,420	0.46
1999	121,829,470	124,270	259,197	383,467	0.31
2000	124,887,140	91,351	159,014	250,365	0.20
2001	127,097,210	77,994	124,507	202,501	0.16

Source: Internal Revenue Service. Includes audits conducted under the Assistant Commissioner (International) outside the jurisdiction of regular IRS district offices. From 2001.

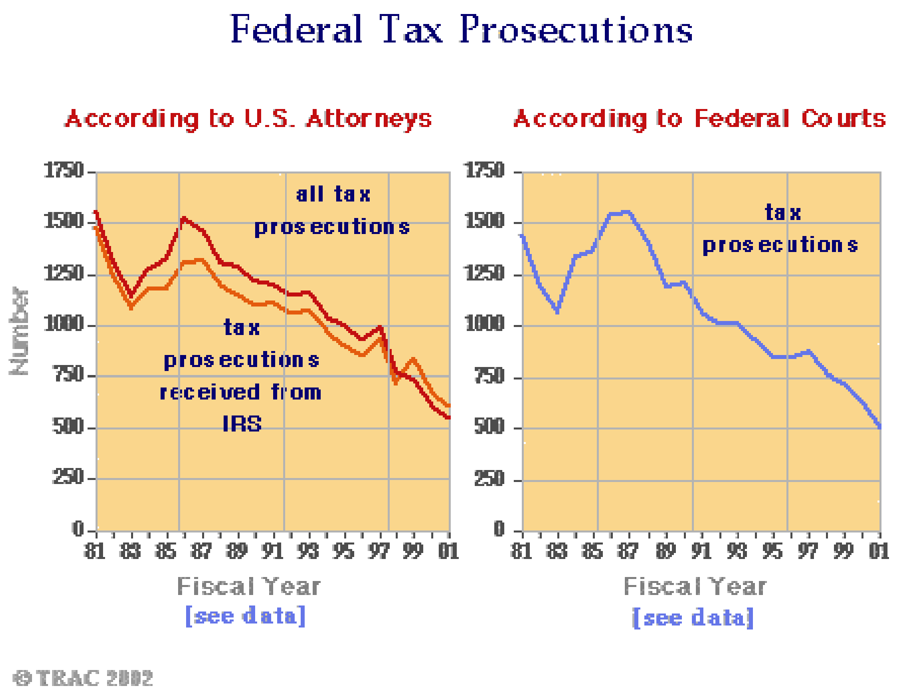
*Returns filed during previous calendar year. Figures prior to 1998 include a small number of correspondence audits conducted by tax examiners from district offices. IRS data systems prior to 1998 did not allow them to be segregated out but treated them as if they were conducted by tax auditors. In1998 there were 16,341 of such tax examiner correspondence audits.



IRS Collection Efforts

Fiscal Year	Total Number of: Levies	Liens	Seizures
1992	3,252,682	1,452,634	11,033
1993	2,584,774	959,356	9,626
1994	2,935,059	812,819	10,166
1995	2,721,823	798,677	10,707
1996	3,108,926	750,225	10,449
1997	3,659,417	543,613	10,090
1998	2,503,409	382,755	2,307
1999	504,403	167,867	161
2000	219,778	287,517	174
2001	447,201	428,376	255

Source: Internal IRS collection reports



Total Federal Tax Prosecutions According to U.S. Courts

Fiscal Year 1981 - 2001

Fiscal Year	Total TaxProsecutions(All Sources)
1981	1,431
1982	1,185
1983	1,060
1984	1,339
1985	1,361
1986	1,547
1987	1,550

1988	1,393
1989	1,190
1990	1,206
1991	1,066
1992	1,015
1993	1,011
1994	931
1995	850
1996	847
1997	873
1998	766
1999	722
2000	632
2001	503

Source: Administrative Office of U.S. Courts.

IV.

IRS NATIONAL RESEARCH PROGRAM AUDITS

IRS News Release (IR-2002-05) and Fact Sheet (FS-2002-07)

The National Research Program (NRP) is a comprehensive effort by the IRS to measure payment, filing and reporting compliance for different types of taxes and various sets of taxpayers. The first stages will focus on individual income taxes, while future stages will measure other taxes and other types of taxpayers. *Filing compliance* will be measured using sample data from the Census Bureau. *Payment compliance* will be measured using information the IRS has available. *Reporting compliance* will be measured by analyzing a sample of tax returns. Obtaining a measure of overall tax compliance will allow the IRS to measure its "bottom line" and allocate it=s resources appropriately.

Historically, IRS has relied heavily on time-intensive, "line-by-line" Taxpayer Compliance Measurement Program (TCMP) audits to establish a baseline measure of reporting compliance. NRP will mostly use information that is already within the IRS computer system to reduce the intrusiveness of audits needed for the program. NRP is not to result in additional audits of taxpayers, and the IRS will use existing audit resources to implement the program.

NRP information will allow the IRS to replace outdated audit formulas and better target its compliance efforts. It should lead to redesigned forms, improved communications, suggested tax law changes and enhanced enforcement focused on non-compliant taxpayers. NRP will give the IRS a road map for selecting future audits - a crucial point because audits of compliant tax returns are unnecessary, burdensome and not cost effective for taxpayers or the IRS.

In order to estimate which returns have the highest likelihood of error, the IRS will use information from the the NRP to update existing screening techniques to select future tax returns for audit. The IRS has not conducted updated research on the distribution of errors in returns for more than 13 years, a period when the economy and the tax law have changed dramatically. As a result, the number of "no change" audits has increased steadily from less than 21% in 1993 to more than 27% presently. By not updating this information, the IRS has less ability to direct its audits and other compliance activities with accuracy and precision.

There are fundamental differences between NRP and the former TCMP audits:

> For the tax year 1988 returns, there were 54,000 TCMP audits.
>
> Starting in September 2002, NRP will begin with respect to less than 50,000 audits out of 132 million individual returns filed. There are four categories of audits ranging from no contact with taxpayers to scaled-back audits that will require less taxpayer substantiation than previous studies. Plans are being made for future surveys of small corporations, partnerships and trusts.

The NRP process will gather information through:

> *No IRS contacts* - about 8,000 returns will be checked relying solely on information already provided to the IRS. No additional taxpayer contact will be required.
>
> *Correspondence with taxpayers* - there will be about 9000 correspondence exchanges with taxpayers. In some of these cases, taxpayers would have heard from the IRS anyway in the normal course of matching information already received by the IRS.
>
> *Less intrusive audits* - instead of the TCMP auditing approach, the IRS will gather more information beforehand from agency records and focus only on select parts of approximately 30,000 returns.Under the TCMP process, audits could take twice as long as a regular IRS audit. Under the NRP approach, they should be comparable to a regular audit.
>
> *Calibration audits* - consisting of about 2,000 audits that will check each line of the return. In a major change from TCMP, these will not require explicit "line-by-line" substantiation by taxpayers of each part of the return so they will not be as burdensome.

Even without NRP, IRS agents would still review about the same total number of tax returns. The IRS will use existing resources in its audit program to implement NRP, and the sample will account for only about 1.1% of the total audit-related contacts planned for the year.

For filing compliance, the IRS will estimate the unpaid individual income tax that is associated with unfiled or late-filed returns. For payment compliance, the IRS will measure the percent of individual income tax on timely-filed returns that was paid on a timely basis. IRS records will be used to produce these measurements. The IRS will also review reporting and payment compliance measures associated with corporation income tax and other taxes, such as employment and excise tax.

The NPR is intended to provide more accurate estimates of the Atax gap@, which is the difference between total tax liability and tax paid voluntarily and timely. The gross tax gap, which includes amounts not collected due to non-filing, underreporting and underpayment of all taxes (individual, corporate, employment and estate) has been estimated at $278 billion for tax year 1998. A 0.1% improvement in the tax compliance rate would increase revenue by more than $1 billion a year.

V.

CURRENCY AND BANKING TRANSACTION REPORTING

The IRS maintains Detroit as the site of the CBRS system that collects and tracks currency transaction reports from all federal agencies. Many examining agents can access this data bank for currency transaction information. The examining agent=s ability to retrieve reports of currency and other suspicious transactions has increased substantially. It is not uncommon for an agent to request that the taxpayer explain specific currency transactions which the agent discovered in a pre-audit analysis of the taxpayer=s return. In some instances, the IRS may begin with a Acompliance check@ which has arisen out of the filing of currency transaction reports and if audit potential is determined during such a compliance check, a thorough examination will follow.

A. *Currency Transaction Report, Form 4789.* This form is filed by financial institutions reporting currency transactions (deposits and withdrawals) involving in excess of $10,000. Financial institutions are also required to report all currency transactions they deem Asuspicious@ regardless of the amount involved. This form identifies the individual making the transaction, the person or organization for whom the Asuspicious@ transaction was conducted and the institution reporting, as well as the amount of the currency involved.

B *U.S. Customs Form 4790.* This form details the international transportation of currency or monetary instruments. Persons transporting either of these must declare themselves to the U.S. Customs Service when leaving the United States or when entering with funds to be declared from non-U.S. sources. Persons who mail or ship funds must also complete this form.

C. *IRS Form 8300.* This form is required whenever cash in excess of $10,000 is received in a trade or business. This form is filed by the business receiving the funds, and it identifies the customer, by name, social taxpayer identification number and address, the transaction, method of payment and other related information. The definition of Acash@ for purposes of filing this report, has included the purchase of cashier=s checks, travelers checks, money orders and bank checks in amounts of less than $10,000. This definition of Acash@ is aimed at detecting currency Astructuring@ activities (i.e., disguising trans-actions to avoid financial reporting requirements.)

D. *IRS Form 8362.* This form is completed by casinos engaged in currency transactions with individuals.

E. *Treasury Form TDF 90-22.1.* This form is required of all entities and individuals having a financial interest in or signature authority over a foreign bank account or financial account with an aggregate value of more than $5,000.

F. *Report of Apparent Crime Form*. Federally insured institutions are required to report to the appropriate federal authorities any suspicious transactions engaged in by their customers. This report consists of multiple pages and requires the identification of the customer and a detailed description of the suspicious conduct. These forms have been known to be filed directly with the U.S. Attorney=s Office and CID.

VI.

JOHN DOE SUMMONS ACTIVITY / USE OF CREDIT CARDS

A.

Update on Southern District of Florida=s Authorization in 2000 for the Service of John Doe Summonses on MasterCard and American Express.

On October 30, 2000, the United States District Court for the Southern District of Florida authorized the Internal Revenue Service to issue John Doe summonses to MasterCard and American Express relating to taxpayer accounts in Antigua, Barbuda, the Bahamas, and the Cayman Islands. The affidavit filed with the IRS petition for Visa International states that MasterCard has already produced over 1.7 million records covering approximately 235,000 accounts issued through 28 banks located in 3 countries.IRS=s ongoing analysis of these data leads it to estimate that between 60,000 and 130,000 U.S. customers are associated with these 235,000 accounts.

American Express has agreed to turn over records relating to people who may be subject to U.S. income taxes with credit card accounts containing addresses in Antigua, Barbuda, the Bahamas, and the Cayman Islands. Additionally, the John Doe summonses served on American Express have been expanded to include American Express Travel-Related Services.

If the MasterCard information is representative of the industry (MasterCard is estimated to have about 30% of this market), there could be 1 to 2 million U.S. citizens with debit/credit cards issued by offshore banks. This compares with only 170,000 Reports of Foreign Bank & Financial Accounts (FBARS) being filed in 2000 and only 117,000 individual 1040 filers indicating they had offshore bank accounts (tax year 1999). U.S. taxpayers with a foreign bank account are required to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts and check the box on Schedule B of their Form 1040.

On August 21,2002 a federal court authorized the Internal Revenue Service to serve an additional summons against MasterCard International for records of offshore credit cards issued by banks in 30 additional countries (*In re Does*,S.D. Fla., No. 02-22404, 8/21/02).

The summons is a "John Doe" summons, designed to allow IRS to identify people who use offshore bank accounts to evade U.S. taxes. IRS suspects people have been using credit cards to access money they diverted into banks in offshore tax havens.The summons covers records for the years 1999, 2000, and 2001 and applies to credit cards issued by banks in Liechtenstein, Switzerland, and numerous Caribbean nations. U.S. District Judge Ursula Ungaro-Benages signed the order in response to a petition the Justice Department filed Aug. 15 (159 DTR GG-1, TaxCore, 8/16/02). IRS has served previous summonses for various recent years against MasterCard International, American Express, and VISA International.

B.

In Re: John Does (N.D. Cal., No. CV 02-0049 Misc., March 27, 2002).

A Federal District Court in San Francisco authorized the Internal Revenue Service to serve a John Doe summons on Visa International. The Visa International John Doe summons requires Visa International to provide the names, addresses, social security numbers, or other identifying numbers and telephone numbers of cardholders or card users of Visa cards issued by banks and financial institutions in more than 30 named countries. If Visa International does not have the requested information, the summons requires that it provide documents relating to card transactions, charges and purchases from January 1, 1999 to the date of compliance with the John Doe summons. The list of countries included in the Visa International John Doe summons includes Switzerland, Luxembourg, Hong Kong, Singapore, Cyprus, Panama, Latvia, and numerous Caribbean countries.

c.

Chronology of IRS John Doe Summons Enforcement

As indicated, the Internal Revenue Service is aggressively attempting to uncover tax-avoidance schemes involving credit cards issued by offshore banks. As reflected in publicly filed documents, a number of actions have taken place:-- On October 30, 2000, a federal judge in Miami issued an order authorizing the IRS to serve John Doe summonses on American Express and MasterCard. These summonses were designed to obtain limited information for 1998 and 1999 revealing U.S. participants in offshore arrangements who hold credit cards issued by banks from Antigua and Barbuda, the Bahamas, and the Cayman Islands. It is not illegal to have an offshore credit card. However, the government asserts there is a reasonable basis for believing that some people might be using offshore credit cards to evade paying U.S. taxes. Credit cards provide easy access to offshore funds and accounts in tax haven countries that allow income to be hidden. U.S. citizens must pay tax on their worldwide income.-- On March 25, 2002, the IRS petitioned the U.S. District Court in San Francisco for permission to serve a John Doe summons on VISA International seeking records on transactions for 1999-2001 using cards issued by banks in over 30 tax haven countries. According to an affidavit filed in support of the VISA petition, MasterCard complied with the John Doe summons by producing electronic database records. These records were for transactions for cards issued in Antigua and Barbuda, the Bahamas and the Cayman Islands. Many of these cards appear to have been issued to U.S. customers. Based on these records, the IRS has apparently developed many cases for civil audits or potential criminal investigation.

-- On March 25, 2002, a stipulation requesting a court order was filed in the U.S. District Court for the Southern District of Florida. The IRS came to a stipulated agreement with American Express. According to the agreement, American Express would provide certain records for 1998 and 1999 on cards for U.S. taxpayers with transactions in the U.S. and mailing addresses in Antigua and Barbuda, the Bahamas or the Cayman Islands.

-- On March 26, 2002, a federal judge in Miami issued an order requiring American Express to comply with the John Doe summons as modified in the agreement.

-- On March 27, 2002, a federal judge in San Francisco issued an order authorizing the IRS to serve the John Doe summons on VISA. -- On August 15, 2002, the IRS petitioned the U.S. District Court for the Southern District of Florida for approval to serve a John Doe summons on MasterCard for records on transactions using credit cards issued by banks in over 30 tax haven countries for 1999-2001.-- On August 20, 2002, a federal judge in Miami issued an order authorizing the IRS to serve the second John Doe summons on MasterCard that was requested on August 15, 2002.

-- On August 29, 2002, the IRS petitioned seven U.S. District Courts across the country for approval to serve John Doe summonses on businesses. These Courts are located in Alexandria, Va.; Atlanta, Ga.; Chicago, Ill.; Dallas, Texas; Newark, N.J.; San Francisco, Calif. and Seattle, Wash. The summonses are directed to a limited number of businesses that engaged in business or financial transactions with individuals using MasterCard payment cards issued by or through banks in Antigua and Barbuda, the Bahamas or the Cayman Islands. The seven courts where the petitions were filed, and the companies named in each petition, include:

- $ the U.S. District Court for the Eastern District of Virginia--America Online, Time Life, and US Airways;
- $ the U.S. District Court for the Northern District of Georgia-- BellSouth Corp., ChoicePoint, Delta Air Lines, EarthLink, Rapid Link Communications, RegSoft.com, and Six Continents Hotels;
- $ the U.S. District Court for the Northern District of Illinois--CDW Computer Centers, Hammacher Schlemmer & Co., Hyatt Corp., and UAL Corp.;
- $ the U.S. District Court for the Northern District of Texas--Accor Lodging North America, AMR Corp., Bulloch, Seger Weaver & Co., CI Host, International Airline Passengers Association, Mannatech, Mary Kay, Omni Hotels, Sabre, Southwest Airlines, and Wyndham International;
- $ the U.S. District Court for the District of New Jersey--AT&T Corp., Avis Rent-A-Car System, Educational Testing Service, Hanover Direct, the Hertz Corp., and Ramada Franchise Systems;
- $ the U.S. District Court for the Northern District of California--American Academy of Ophthalmology, Beyond.com Corp., DHL Worldwide Express, eBay, Fairmont Hotels & Resorts, Gap, and Yahoo!; and
- $ the U.S. District Court for the Western District of Washington--Alaska Air, Amazon.com, AT&T Wireless Services, Microsoft Corp., Nordstrom, and RealNetworks.

These actions seek a limited amount of information from these companies to help the IRS identify individuals holding offshore credit cards. In some instances, the IRS has been unable to precisely identify individuals based on the information received from MasterCard. (MasterCard does not directly issue cards to individuals but processes transactions for member banks licensed to issue the credit cards.)To obtain or verify the actual names of some individuals, the IRS is seeking information from some of the merchants where purchases were made. The IRS believes these firms, as part of the routine course of business, have information in their records identifying the people who made these transactions. More than 40 companies are named in the seven summonses being requested. They include airlines, hotels, rental car companies and Internet providers where offshore cards were used. Information gathered in this process will likely be used for possible civil examinations and criminal investigations.

D.
<u>GAO Report: Money Laundering Through Credit Cards</u>

Although money laundering involves an estimated $500 billion annually, the extent of money laundering through credit cards is unknown, the General Accounting Office said in a report issued Aug. 21, 2002. *The GAO report, Money Laundering: Extent of Money Laundering Through Credit Cards Is Unknown (GAO-02-670, July 2002), is available on the GAO Web site at http://www.gao.gov/cgi-bin/getrpt?GAO-02-670.*

There is little evidence of money laundering in U.S. banks and financial institutions, according to the Treasury Department's Financial Crimes Enforcement Network (FinCEN) and other law enforcement officials questioned by GAO. However, investigations by Congress and the Internal Revenue Service indicate that credit card accounts maintained by banks in offshore jurisdictions with low taxes and financial secrecy are vulnerable to money laundering.

The GAO report describes six scenarios in which credit cards could be used in money laundering schemes, but found little indication that companies involved in credit card transactions had ever detected any money laundering activities.

Money laundering involves three stages, GAO said:

- placement, where illicit cash is deposited into the financial system or converted into monetary instruments;
- layering, or moving funds to other financial institutions; and
- integration, or using the funds to buy assets or fund further activities.

Credit cards are unlikely to be used in the initial stage, because the credit card industry restricts cash payments. However, credit card accounts could be used in the layering or integration stage, for example, by using illicit funds in a bank account to pay a credit card bill for goods purchased.

The credit card industry includes credit card associations, such as VISA and MasterCard, that license banks to issue their cards, and merchants to accept their cards; "issuing" banks; "acquiring" banks that process transactions for merchants; and other third parties that process transactions for the banks. American Express and Discover Card are full-service credit card companies that issue their own cards directly to customers. According to the GAO, credit card companies do not have specific anti-money laundering (AML) programs because they claim that money laundering with credit cards is unlikely. Other parties involved in processing credit card transactions screen them for fraud and credit risk, but not for money laundering. The parties may report suspicious activity to the government or to law enforcement.

The credit card industry could not cite any money laundering cases detected through its fraud controls, and GAO questioned whether this indicated a lack of money laundering activity or the inadequacy of the detection systems. Treasury told GAO the industry needs to build on its existing fraud detection systems to improve its ability to detect money laundering.

The USA PATRIOT Act requires credit card associations to design and have anti-money laundering programs in place in 2002, subject to oversight by IRS. The programs must be "reasonably designed to prevent the credit card system from being used to launder money or finance terrorist activities."It is obviously too early to evaluate the effectiveness of these requirements.

VII.

ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD)

www.oecd.org

ATax havens@ have flourished over the last 20 years. The International Monetary Fund estimates that assets worth more than $5 trillion are held in offshore tax havens. Governments have a duty to protect their interests in the face of those who use tax havens to avoid their legal obligations to pay taxes in their countries of residence. In support of that obligation, the OECD publishes a List of Uncooperative Tax Havens. Uncooperative tax havens represent a threat not only to the tax systems of developed and developing countries but also to the integrity of the international financial system. The seven jurisdictions on the OECD=s list include: Andorra, Liechtenstein, Liberia, Monaco, The Marshall Islands, Nauru and Vanuatu.

More than 30 other offshore financial centers have pledged to work with OECD countries to counter their harmful tax practices. Former Atax haven@ countries participating in the OECD have pledged to eliminate their own harmful tax practices by April 2003. Cooperating countries include Anguilla, Antigua, Aruba, Bahamas, Bahrain, Belize, British Virgin Islands, Cook Islands, Gibralter, Grenada, Guernsey, Isle of Man, Jersey, Montserrat, Netherlands Antilles, Niue, Nevis, Panama, St. Kitts, Seychelles, and the US Virgin Islands. These countries have agreed to provide transparency in accounting standards and with regard to the ownership of companies, and a willingness to exchange information with other countries. OECD member countries permit access to bank information, directly or indirectly, for all tax purposes so that tax authorities can fully discharge their revenue raising responsibilities and engage in effective exchange of information with their treaty partners. OECD member countries further agree to eliminate anonymous accounts and require identification of bank customers and beneficial owners of accounts.

The OECD aims to foster economic growth and development and ensure efficient and equitable flow of capital world-wide by promoting fair competition on tax rates. By getting commitments from more than thirty offshore financial centers to cooperate in fighting harmful tax practices, the OECD is attempting to protect the tax base not only of OECD countries but also of developing countries. By promoting transparency and cooperative agreements between all economies, OECD=s work contributes to efforts to counter money laundering and the financing of terrorism (and strengthen the international financial system).

VIII.

USA PATRIOT Act

On October 26, 2001, President Bush signed into law the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the AAct@). The Act adds enhanced money laundering provisions to Chapter 53 of Title 31 of the United States Code. Many of these provisions may also have implications for tax investigative and tax withholding purposes.

Qualified Intermediary Provisions - The Qualified Intermediary (AQI@) provisions would require a QI to provide the identity of the beneficial owner and the production of documents if certain new money laundering provisions apply, notwithstanding foreign bank secrecy laws. Another provision has the potential for requiring all foreign persons who open or maintain an account in the U.S.to obtain an identifying number. Clearly, this new legislation raises issues about potential conflicts with foreign bank secrecy laws that impose civil or even criminal sanctions, on the release of confidential information about an account holder.

Payable Through or Correspondent Account Provisions - A foreign financial institution that opens or maintains a Apayable-through@ (an account through which a foreign financial institution allows its customers to engage in usual banking activity) or correspondent account with a domestic financial institution or agency as a condition to opening or maintaining account must (i) identify each customer of the foreign financial institution who is permitted to use, or whose transactions are routed through, the account and (ii) obtain information about those customers that is Asubstantially comparable@ to information that must be obtained about U.S. customers.

Know Your Customer Procedures Provision - New Section 5318(l) of Title 31 mandates the application of AKnow Your Customer@ (KYC) procedures for U.S. financial institutions. Under such rules, a U.S. financial institution must verify the identity of an account holder and maintain records of the information used to verify the account holder=s identity.

U.S. Account Maintained by Foreign Persons Provision - Another special measure would permit the Treasury Department to require a domestic financial institution to obtain information about the beneficial owner of any account opened or maintained in the United States by a foreign person.

Summons Authority Over Foreign Bank Records Provision - The Act adds a new subsection to Section 5318 of Title 31 that authorizes either the Treasury Department or the Justice Department to issue a summons or subpoena to a foreign bank that maintains a correspondent account in the U.S. for records maintained by the bank (including records maintained outside the U.S.) that relate to the U.S. correspondent account. The foreign bank must respond to the summons request within seven days of receipt of the summons request. This provision is comparable to the summons provision under Section 6038A(e)(1) that permits IRS to obtain records with respect to an U.S.-connected transaction maintained outside the U.S. by a foreign person related to a foreign-owned U.S. corporation.

IX.

<u>ATAX SHELTERS@</u>

Curbing abusive Atax shelters@ is a priority for the Internal Revenue Service and Treasury Department. ATax shelters@ are generally defined by IRC Section 6662 (d)(2)(C)(iii) as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such arrangement is the aviodance or evasion of Federal income tax. Developing a strategy to deal with abusive tax shelters is a major strategic initiative of Large and Mid-Size Business (LMSB). LMSB=s Office of Tax Shelter Analysis (OTSA) is responsible for planning, coordinating, and providing assistance to revenue agents working tax shelter issues. Tax shelters have been described as providing IRS with a "target rich environment."

A.

<u>*IRS Announcement 2002-2*</u>

On December 20, 2001, the IRS issued Announcement 2002-2, an initiative intended to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. If a taxpayer disclosed any item in accordance with the provisions of Announcement 2002-2 before April 23, 2002, the IRS agreed to waive the accuracy related penalty under ' 6662(b)(1), (2), (3), and (4) for any underpayment of tax attributable to that item.

LMSB OTSA received approximately 1,600 Disclosures from 1,180 taxpayers covering 1,506 tax returns involving more than $30 billion in claimed losses or deductions. Many related to "listed transactions"that would be required to be disclosed under current regulations, about 300 disclosures related to transactions relatively unknown to OTSA, OTSA received 24 Amended returns, and OTSA received 4-5 checks totaling more than $4 million. The universe of promoters greatly exceeded IRS expectations with approximately current 30 current audits of promoters - including of law and accounting firms. Approximately 129 summons have been issued to promoters - and LMSB OTSA is coordinating it=s efforts with the Department of Justice for possible summons enforcement actions. LMSB agents are to develop penalty issues in all cases involving tax shelters.

LMSB is looking to resolve these cases by:

1) Use of "Special Forces" - highly trained agents for each type of transaction,
2) Possibility of Global Settlements,
3) Increased third party summons activity seeking investor lists,
4) Issuance of Statutory Notices of Deficiency earlier in process,
5) Use Fast Track Appeals Mediation (settle or not within 120 days).

LMSB is working on advising Appeals Officers re consistent issues in these transactions and the basis for any penalties being asserted and designating these transactions as Appeals Coordinated Issues such that they can=t be settled by the Appeals Team Chief without the concurrence of Industry Specialist at Appeals. LMSB has been attempting to focus Appeals on penalties and the reasonableness of penalties and lack of basis for opinions that do not state relevant facts, are provided by the promoter, or do not cover relevant issues.

B.

<u>Temporary Regulations</u>

The Temporary Regulations [Section 1.6011-4T(b)(3) and 301.6111] set forth various characteristics that may be indicative of tax shelter activity. Treasury and IRS believe taxpayers and their advisers have been too narrowly interpreting the present Temporary Regulations and are reworking the disclosure, registration, and listing requirements of the Temporary Regulations (which are set to expire in February 2003). Treasury and the IRS are trying to create a uniform definition of transactions that must be disclosed and registered and for which investor lists must be maintained. Effective Dates :The following regulations are applicable June 14, 2002.

Explanation of Provisions

1. Application of ''1.6011-4T to Individuals, Trusts, Partnerships, and S Corporations

Section 1.6011-4T generally provides that certain corporate taxpayers must disclose their participation in listed and other reportable transactions that meet the projected tax effect test by attaching a written statement to their Federal income tax returns. It has been determined that a number of these transactions are entered into by noncorporate taxpayers. Accordingly, in order to obtain information regarding potentially abusive transactions entered into by noncorporate taxpayers, the requirement to disclose under ''1.6011-4T is extended to individuals, trusts, partnerships, and S corporations that participate, directly or indirectly, in listed transactions. Thus, if a partnership or an S corporation participates in a listed transaction, that partnership or S corporation must disclose its participation under ''1.6011-4T and the partners and shareholders of the partnership or S corporation, respectively, also must disclose their participation under ''1.6011-4T. The IRS and Treasury plan to extend in future guidance the requirement to disclose under ''1.6011-4T to other reportable transactions entered into by individuals, trusts, partnerships, and S corporations.

2. Indirect Participants

Section 1.6011-4T makes reference to taxpayers who participate directly or indirectly in reportable transactions. In order to obtain information about potentially abusive transactions entered into by taxpayers, the IRS and Treasury have provided clarification regarding indirect participation in a reportable transaction. A taxpayer will have indirectly participated in a reportable transaction if the taxpayer knows or has reason to know that the tax benefits claimed from the taxpayer's transaction are derived from a reportable transaction. However, this clarification does not imply that a taxpayer's participation in a transaction did not otherwise qualify as indirect participation in a reportable transaction for purposes of ''1.6011-4T, as in effect prior to June 14, 2002.

For example, Notice 95-53 (1995-2 C.B. 334), describes a lease stripping transaction in which one party (the transferor) assigns the right to receive future payments under a lease of tangible property and receives consideration which the transferor treats as current income. The transferor later transfers the property subject to the lease in a transaction intended to qualify as a substituted basis transaction, for example, a transaction described in section 351. In return, the transferor receives stock (with low value and high basis) from the transferee corporation. The transferee corporation claims the deductions associated with the high basis property subject to the lease. The transferor and transferee corporation have directly participated in the listed transaction. If the transferor subsequently transfers the high basis/low value stock to a taxpayer in another transaction intended to qualify as a substituted basis transaction and the taxpayer uses the stock to generate a loss, and if the taxpayer knows or has reason to know that the tax loss claimed was derived from the lease stripping transaction, then the taxpayer is indirectly participating in a reportable transaction. Accordingly, the taxpayer must disclose the reportable transaction and the manner of the taxpayer's indirect participation in the reportable transaction under the provisions of ''1.6011-4T.

3. Substantially Similar Transactions

Sections 1.6011-4T and 301.6111-2T make reference to *substantially similar* transactions. Some taxpayers and promoters have applied the *substantially similar* standard in an overly narrow manner to avoid disclosure. For instance, some taxpayers and promoters have made subtle and insignificant changes to a listed transaction in order to claim that their transactions are not subject to disclosure. Others have taken the position that their transaction is not substantially similar to a listed transaction because they have an opinion concluding that their transaction is proper. The IRS and Treasury believe that these interpretations are improper. Accordingly, the regulations are modified in ''1.6011-4T and ''301.6111-2T to clarify that the term *substantially similar* includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Further, the term *substantially similar* must be broadly construed in favor of disclosure. This modification does not imply that a transaction was not otherwise the same as or substantially similar to a listed transaction prior to this modification.

For example, Notice 2000-44 (2000-2 C.B. 255), sets forth a listed transaction involving offsetting options transferred to a partnership where the taxpayer claims basis in the partnership for the cost of the purchased options but does not reduce basis under section 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the options. Transactions using short sales, futures, derivatives or any other type of offsetting obligations to inflate basis in a partnership interest would be the same as or substantially similar to the transaction described in Notice 2000-44. Moreover, use of the inflated basis in the partnership interest to diminish gain that would otherwise be recognized on the transfer of a partnership asset would also be the same as or substantially similar to the transaction described in Notice 2000-44.

As another example, Notice 2001-16 (2001-1 C.B. 730), sets forth a listed transaction involving a seller (X) who desires to sell stock of a corporation (T), an intermediary corporation (M), and a buyer (Y) who desires to purchase the assets (and not the stock) of T. M agrees to facilitate the sale to prevent the recognition of the gain that T would otherwise report. Notice 2001-16 describes M as a member of a consolidated group that has a loss within the group or as a party not subject to tax. Transactions utilizing different intermediaries to prevent the recognition of gain would be the same as or substantially similar to the transaction described in Notice 2001-16. An example is a transaction in which M is a corporation that does not file a consolidated return but which buys T stock, liquidates T, sells assets of T to Y, and offsets the gain recognized on the sale of those assets with currently generated losses.

4. Projected Tax Effect Test for Listed Transactions

Section 1.6011-4T provides that a reportable transaction is a transaction that meets the projected tax effect test and is either a listed transaction or a transaction that has at least two of five specified characteristics. Under '' 1.6011-4T, the projected tax effect test for listed transactions is met if the taxpayer reasonably estimates that the transaction will reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or by a total of more than $2 million for any combination of taxable years in which the transaction is expected to have the effect of reducing the taxpayer's Federal income tax liability. The IRS and Treasury have determined that the projected tax effect test for listed transactions results in inadequate disclosure. Accordingly, the projected tax effect test will no longer apply to listed transactions. Thus, any individual, trust, partnership, S corporation, or other corporation that participates in a listed transaction must report it under the provisions of '' 1.6011-4T.

5. Time of Providing Disclosure

In general, the disclosure statement for a reportable transaction must be attached to the taxpayer's Federal income tax return for each taxable year for which the taxpayer's Federal income tax liability is affected by the taxpayer's participation in the transaction. In the case of a taxpayer that is a partnership or an S corporation, the disclosure statement for a listed transaction must be attached to the taxpayer's Federal income tax return for each taxable year ending with or within the taxable year of any partner or shareholder whose income tax liability is affected or is reasonably expected to be affected by the partnership's or the S corporation's participation in the transaction. In addition, at the same time that the disclosure statement is first attached to the taxpayer's Federal income tax return, the taxpayer must file a copy of that disclosure statement with the Office of Tax Shelter Analysis.

If a transaction becomes a reportable transaction (e.g., the transaction subsequently becomes one identified in published guidance as a listed transaction described in '' 1.6011-4T(b)(2), or there is a change in facts affecting the expected Federal income tax effect of the transaction) on or after the date the taxpayer has filed the return for the first taxable year for which the transaction affected the taxpayer's or a partner's or a shareholder's Federal income tax liability, the disclosure statement must be filed as an attachment to the taxpayer's Federal income tax return next filed after the date the transaction becomes a reportable transaction (whether or not the transaction affects the taxpayer's or any partner's or shareholder's Federal income tax liability for that year) and at that time a copy of that disclosure statement must be filed with the Office of Tax Shelter Analysis. Notwithstanding the effective date of these regulations, for purposes of '' 1.6011-4T, as in effect prior to June 14, 2002, a corporate taxpayer was required to disclose a transaction that later became reportable on the corporation's next filed Federal income tax return even if the transaction did not affect the corporation's Federal income tax liability for that year.

Regardless of whether the taxpayer plans to disclose the transaction under other published guidance, for example, Rev. Proc. 94-69 (1994-2 C.B. 804), the taxpayer also must disclose the transaction in the time and manner provided for under the provisions of this regulation. Notwithstanding the effective date of these regulations, a corporate taxpayer was required to disclose a transaction in the time and manner provided for in ' ' 1.6011-4T in effect prior to June 14, 2002, regardless of whether the taxpayer planned to disclose the transaction under other published guidance.

Treasury has proposed stiff penalties for failing to disclose. The government is also working on the forms to be used for disclosure. The forms will be tailored to seek information based on certain types of transactions. For example, the disclosure form for reporting large losses might have a box to check if a foreign tax-exempt party participated in the transaction.

C.
 Tax Shelter Transparency Act (S. 2498) by Sens. Max Baucus (D-Mont.) and Charles Grassley (R-Iowa), PROPOSED LEGISLATION as of May 10, 2002

The Tax Shelter Transparency Act would amend the Internal Revenue Code of 1986 to require adequate disclosure of transactions which have a potential for tax avoidance or evasion, and for other purposes. It is intended to provide a degree of certainty to taxpayers and their tax advisors about registration, list maintenance and disclosure on tax returns. According to the Treasury Department, "If a promoter is comfortable with selling a transaction, a taxpayer is comfortable with entering into that transaction, and a tax practitioner is comfortable with advising that the transaction is proper, then they all should be comfortable with the IRS knowing about and understanding the transaction."

Tax shelters are generally deemed highly aggressive positions taken by taxpayers on their tax returns to minimize or avoid taxes. Under current law, there are specific sections of the Internal Revenue Code and several penalty provisions that attempt to curtail perceived abuses and encourage compliance. Typically, these specific sections are generally after-the-fact fixes which keep the Treasury Department and the IRS years behind in their enforcement efforts. Current penalty provisions do not encourage taxpayers to disclose questionable items on their tax return nor sufficiently deter them from entering into tax shelters. In most cases, taxpayers have been able to get relief from the penalties either through negotiation or reliance on advisor opinions.

Taxpayers: Under the Tax Shelter Transparency Act, there are three types of transactions for purposes of disclosure and accuracy-related penalties: Listed Transactions, Reportable Transactions, and Other Transactions:

> *Listed Transactions:* Treasury considers Listed Transactions [within the meaning of IRC Section 6662 (d)(2)(D) and Temporary Regulations Section 1.6011-4T(b)(2)] to be abusive tax shelters and publicly discloses these transactions so that taxpayers can readily determine whether any of their transactions are Listed Transactions. See IRS Notice 2001B51, 2001-34 IRB 190.
>
> Because Listed Transactions are publicly disclosed, the Tax Shelter Transparency Act would impose significant penalties for non-disclosure of Listed Transactions. Diagram 1 depicts the penalties that are imposed on listed transactions. Failure by the taxpayer to disclose the transaction results in an automatic flat dollar penalty of $200,000 for large taxpayers (i.e., any corporation, partnership, or trust with gross receipts over $10 million and individuals with net worth over $2 million) and $100,000 for small

taxpayers. Additionally, if the taxpayer is required to file with the SEC, the penalty must be reported to the SEC. These penalties are based solely upon the failure to disclose, and do not depend upon the ultimate success of the taxpayer in challenging the merits of their Listed Transaction.

In addition, any underpayment that is attributable to a nondisclosed Listed Transaction will be subject to a 30% strict liability, nonwaivable accuracy-related penalty which must be reported to the SEC. On the other hand, if the taxpayer discloses the Listed Transaction, any tax underpayment that is attributable to the transaction will be subject to a 20% accuracy related penalty.

Reportable Abusive Transactions: Reportable Transactions are transactions that meet one of several objective criteria established by Treasury. Based on current regulations, and the proposals put forward by the Administration, these transactions are anticipated to include, but are not limited to: significant loss transactions; transactions with brief asset holding periods; transactions marketed under conditions of confidentiality; transactions subject to indemnification agreements; and certain transactions with a certain amount of book-tax difference.

Diagram 2 sets forth the penalty regime for Reportable Transactions. Failure by the taxpayer to disclose a Reportable Transaction results in an automatic flat dollar penalty of $100,000 for large taxpayers and $50,000 for small taxpayers. There is no SEC reporting requirement for a failure to disclose. These penalties are based solely upon the failure to disclose, and do not depend upon the ultimate success of the taxpayer in challenging the merits of their Reportable Transaction.

Reportable Transactions are subject to a filter to determine whether there is a significant purpose of tax avoidance that would merit harsher treatment of the transaction. First, any understatement attributable to a nondisclosed Reportable Transaction that has a significant purpose of tax avoidance is subject to a 25% strict liability, nonwaivable accuracy-related penalty which must be reported to the SEC. On the other hand, if a nondisclosed Reportable Transaction does not have a significant purpose of tax avoidance, any tax underpayment attributable to the transaction is subject to a 20% accuracy related penalty, to the extent the underpayment exceeds a certain amount, unless the transaction has a more likely than not probability (greater than 50%) of being sustained on its merits.

Second, if the taxpayer discloses a Reportable Transaction that has a significant purpose of tax avoidance, the taxpayer is not subject to a higher accuracy-related penalty (current 20% applies), the transaction must have a more likely than not probability of being sustained on the merits if challenged by the IRS, and heightened penalty waiver exception requirements apply. If the transaction does not have a significant purpose of tax avoidance, the taxpayer is still not subject to a higher accuracy-related penalty (current 20% applies), the transaction need only have a reasonable basis if challenged by the IRS, and the current law penalty waiver exception requirements apply.

Other Transactions: Transactions that are neither a Listed nor a Reportable Transaction could still be subject to the accuracy-related penalty. The Tax Shelter Transparency Act makes three modifications to the current accuracy-related penalty requirements: elevates the standards for reporting in order to provide meaningful incentives to disclose; conforms standards for taxpayers and tax practitioners; and changes the floor for understatements. Diagram 3 sets forth the operation of these modifications. If the taxpayer fails to disclose the transaction, the taxpayer must have a more likely than not belief that the transaction will be sustained on its merits if challenged by the IRS. This standard is higher than "substantial authority," the standard applicable to non-tax shelter transactions under present law. The definition of "substantiality" for purposes of determining whether there is a substantial understatement is if the amount of the understatement exceeds the lesser of $10 million or 10% of the tax required to be shown on the return for the taxable year.

Frivolous Filings: The Tax Shelter Transparency Act increases the penalty for filing a frivolous tax return to $5,000.

Reasonable Cause Waiver: A taxpayer may not avoid the penalty through reliance on an opinion that is rendered by a tax advisor who has a financial interest in the transaction or otherwise has a conflict of interest or lack of independence. In addition, a tax opinion based on unreasonable facts, assumptions, or representations will be similarly disqualified, even if it is rendered by an otherwise independent tax advisor.

Advisors and Promoters: To enhance the ability of the IRS and the Treasury Department to obtain information about transactions deemed abusive, the Tax Shelter Transparency Act expands the types of transactions that must be registered with the IRS and does not limit the legislation to corporate transactions. The Tax Shelter Transparency Act would also enhance the government=s ability to enjoin conduct related to tax shelters.

The Tax Shelter Transparency Act increases the penalty imposed on material advisors who refuse to maintain lists of their transaction participants, as required by the regulations. A Amaterial advisor@ is any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing or carrying out any Reportable Transaction. If a material advisor fails to provide the IRS with a list of investors in a Reportable Transaction within 20 days after receipt of a written request by the IRS to provide such a list, the promoter would be subject to a penalty of $10,000 for each additional day that the requested information is not provided. The penalty would be imposed for each investor list that a promoter fails to maintain or delays in providing to the IRS. The IRS would have the discretion to extend the deadline or waive all or a portion of the penalty upon a showing of reasonable cause.

The Tax Shelter Transparency Act adds a provision affirming the authority of the Treasury Department to censure tax advisors or impose monetary sanctions against tax advisors and firms that participate in tax shelter activities and practice before the IRS.

Public Comment: Chairman Baucus and Ranking Member Grassley have invited public comment on the Tax Shelter Transparency Act. Comments should be directed to: John Angell, Majority Staff Director, and Kolan L. Davis, Republican Staff Director, of the Senate Finance Committee, 219 Dirksen Senate Building, Washington, D.C. 20510.

X.

ALTERNATIVE DISPUTE RESOLUTION OF TAX CASES

The IRS has instituted several settlement initiatives as alternatives to the traditional Appeals Office conference. The IRS Restructuring and Reform Act of 1998 added IRC Sec. 7123, codifying (with certain modifications) these alternative appeals dispute resolution procedures. IRC Sec. 7123(a) states that the Secretary of the Treasury shall prescribe procedures for taxpayers to request early referral of one or more unresolved issues to the Appeals Office. The Act required the Treasury to establish a pilot program under which the taxpayer and Appeals may jointly request binding arbitration. In addition, the Act required the Treasury to prescribe procedures under which a taxpayer or the IRS Appeals Office may request nonbinding mediation on any issue unresolved at the conclusion of appeals procedures or unsuccessful attempts to enter into a closing agreement under IRC Sec. 7121 or an offer in compromise under IRC Sec. 7122.

A.

Early Referral Procedures

Any taxpayer can request an early referral of an issue(s) from the Examination or Collection Division to Appeals. The issue=s resolution must be reasonably expected to help resolve the entire case quickly, the IRS and the taxpayer must agree to the referral, the issue must be fully developed and be part of a case where the remaining issues are not expected to be resolved before Appeals can resolve the referral issues.

Issues cannot be referred if (Rev. Proc. 99-28):

– a 30-day letter has been issued,

- the issue has been designated for litigation by Chief Counsel,

- competent authority assistance has been requested, or

- the issue is part of a "whipsaw" transaction (one where a change in the transaction will hurt one taxpayer but help another taxpayer).

Collection early referrals are also permitted.

An early referral request must be made in writing to the appropriate Group Manager. The request must identify the taxpayer and the tax periods, as well as the issues for which early referral is requested, and it must set forth the taxpayer=s position on the issues, including a statement of facts and law on each issue.

B.

Worker Classification Early Referral

The IRS allows taxpayers undergoing an audit to request an early referral of one or more employment tax issues from the Examination Division to the Appeals Office. Early referral of employment tax issues must be initiated by the taxpayer and approved by the appropriate IRS official. Examples of issues appropriate for early referral include:

- whether a worker is an employee or an independent contractor under the common law control test,

- whether a worker is a statutory employee or a statutory nonemployee, and

- whether the classification of a worker as an independent contractor is eligible for relief under Sec. 530 of the Revenue Act of 1978.

C.

Mutually Accelerated Appeals Process (MAPP)

The Mutually Accelerated Appeals Process (MAPP) is available for cases involving $10 million or more in disputed taxes. Under MAPP, Appeals reviews current large cases to determine whether there is an opportunity to shorten the audit cycle by adding team members, reallocating team workload, or creating new teams. At the same time, the taxpayer under audit must consent to MAAP and must also agree to add resources to help shorten the audit time.

D.

Pre-filing Agreements and Comprehensive Case Resolution

LMSB offers the Pre-filing Agreement/Comprehensive Case Resolution program. First instituted as a pilot program in 2000 by Notice 2000-12, the program was expanded to cover all LMSB taxpayers and made permanent in Rev. Proc. 2001-22. Under the prefiling program, LMSB taxpayers can request the examination of specific issues in a tax return before filing the return. The purpose of a pre-filing agreement is to resolve factual questions and well-settled principles of tax law before the return is filed.

E.

Industry Issue Resolution Program

Started in December 2000, the Industry Issue Resolution Program is designed to provide LMSB taxpayers guidance on frequently disputed tax issues common to a significant number of taxpayers (Notice 2000-65). The ultimate guidance could be in the form of a revenue procedure permitting taxpayers to adopt the recommended treatment on a future tax return.

According to Notice 2000-65, the most appropriate issues will be those that create uncertainty about the appropriate treatment of a given factual situation, involve repetitive examinations of the same issue, impact a significant number of taxpayers in a given industry, and have a factual determination as a major component of determining a resolution.

F.

Arbitration and Mediation

The IRS Restructuring and Reform Act of 1998 required the IRS to make mediation and arbitration available to all taxpayers.

Arbitration. In arbitration, a neutral person or panel renders a decision following receipt of testimony and other information. The arbitrators are not bound by precedent, and can give whatever weight to the evidence they deem appropriate. In most cases, arbitration is binding on the parties. The Tax Court (in Rule 124) provides for arbitration as an alternative to litigation.While similar to a trial, the arbitration hearing is more informal. In binding arbitration, the arbitrator=s decision is final.

Mediation. Mediation is nonbinding and involves negotiations between the IRS and the taxpayer. A neutral mediator works with both parties to resolve their case. The mediator does not make a decision but helps the parties recognize the strengths and weaknesses of their case and identify alternatives to their positions in order to resolve the issues. Mediation is most successful in factual disputes where there are significant differences between the parties= positions. Under *Fast Track Mediation*, IRS Appeals Officers serve as mediators while a case is still in Compliance (SB/SE or LMSB).

Mediation is essentially negotiation with an intermediary. The parties may meet together, or the mediator may shuttle back and forth with offers and counteroffers. The mediator helps the parties focus on their case=>s strengths and weaknesses and what a likely outcome may be, given the facts. In effect, the parties negotiate a compromise, with the mediator=s assistance. No trial and no other legal proceedings take place.

208094.1

TABLE OF CONTENTS

208094.1